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**Requestor (if any):**
Roger W. Robinson, Jr., Senior Director for International Economic Affairs

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

26 FEB 1985

MEMORANDUM FOR: Roger W. Robinson, Jr.
Senior Director for International Economic Affairs
National Security Council
Washington, D.C. 20500

FROM: [redacted] STAT
Director of Global Issues

SUBJECT: Exchange Market Intervention

The attached analysis of Exchange Market Intervention was prepared at your request. If you have any questions or comments, please call [redacted] or secure telephone [redacted] STAT STAT

[redacted] STAT

Attachment:
<u>Exchange Market Intervention</u> (FOUO)
GI M 85-10055, February 1985, (FOUO)

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

25 February 1985

# Exchange Market Intervention

## Summary

This report examines some of the motives and the effectiveness of exchange market intervention. It draws heavily on the findings of the March 1983 report by the working group established after the June 1982 Economic Summit to examine the effectiveness of exchange rate intervention. The analysis indicates that exchange rate intervention can serve as a useful tool in meeting short-term objectives, such as smoothing out large intra-day exchange rate fluctuations. Intervention as a tool for meeting longer term objectives, however, seems to be ineffective in the absence of supportive changes in domestic economic policy.

This memorandum was prepared by [redacted] STAT
[redacted] Economics Division, Office of Global Issues, at the request of Roger Robinson, Senior Director, International Economic Affairs and Special Assistant to the President, National Security Council. Information available as of 25 February 1985 was used. Comments and queries may be addressed to Chief, Financial Issues Branch, Economics Division, Office of Global Issues on [redacted] STAT

GI M 85-10055

# Exchange Market Intervention

Foreign exchange intervention can be defined as any sale or purchase of currency that monetary authorities undertake in exchange markets. In the current economic environment, proposals for intervention--including recommendations by some G-7 members for joint action--entail the Federal Reserve and other G-7 central banks selling dollars in exchange for other currencies. These proposals are made in the hope of either stemming or reversing the rapid rise in the value of the dollar.

## Objectives of Intervention

Three common arguments for exchange rate intervention are: to counter disorderly market conditions; to resist exchange movements that are believed unjustified in light of economic fundamentals; and to avoid exchange rate levels that might unduly offset international price competitiveness or aggravate inflation.

Authorities in the G-7 countries--Canada, France, Italy, Japan, West Germany, United Kingdom, and the United States--have intervened a number of times to counter disorderly market conditions. The definition of disorderly markets varies but usually includes substantial widening of bid-ask spreads, large exchange rate movements within a trading day, perceptions that trading has become thin, and at times, judgments that market psychology is generating self-sustaining exchange rate movements. For example, some economists state that the rapid appreciation of the dollar is feeding upon itself. All G-7 countries have occasionally intervened in order to offset the destabilizing impact of sudden events of a non-economic nature.

Authorities in all G-7 countries have also intervened in order to resist exchange rate movements that they believed were unjustified in light of the economic fundamentals. One argument currently cited for intervening against the dollar is that it is currently overvalued in relation to the goods and services it can purchase abroad as compared to in the United States. The objective for intervening is to "buy time" until the market participants recognize that their assessments are faulty or for the authorities themselves to reassess their policies and implement any change that was considered to be necessary.

Most G-7 countries also have been influenced at times by a desire to avoid exchange rate movements that lessen international price competitiveness or exacerbate inflationary pressures. US businessmen and farmers argue, for example, that the strong dollar is putting their products at a competitive disadvantage, while Europeans complain of the inflationary impact that a strong

dollar is having on oil imports. For example, France is paying more than twice as many francs for a barrel of imported oil than it would if the dollar-franc exchange rate had remained constant over the past three years.

## Effectiveness of Intervention

The effects of intervention operations on the exchange market depend on whether the intervention is sterilized or unsterilized. When monetary authorities intervene in the market by buying (selling) foreign exchange, the net foreign assets of the central bank increase (decrease) causing the monetary base to rise (fall). This will eventually lead to changes in the various money stocks, interest rates, and inflation rates. To sterilize the monetary effect of intervention the monetary authorities will sell (purchase) government securities to offset purchases (sales) of foreign exchange leaving the monetary base unchanged.

Sterilized intervention will offset exchange rate behavior only by altering the relative stocks of domestic and foreign currency assets held in investors' portfolios. If assets denominated in different currencies are perfect substitutes, then investors will be indifferent to the relative stock of each that they hold. This would imply that sterilized intervention has no impact on exchange rates. If different currencies are not viewed as perfect substitutes, than sterilized intervention will affect exchange rates. The degree of effectiveness will depend on how close the currencies serve as substitutes.

Unsterilized intervention implies a change in monetary policy. For example, if the Federal Reserve conducted unsterilized intervention to reduce the value of the dollar, the US monetary base would increase. This would lead to an increase in the money stocks and inflationary pressures would mount.

## Results of 1983 Working Group

At the June 1982 Economic Summit held in Versailles a working group was established for the purpose of reporting on the effectiveness of intervention. The working group included several economists from each of the G-7 countries. According to the working group's findings, intervention was felt to be an effective tool in influencing the behavior of exchange rates in the short run. In particular, it had been effective in narrowing bid-offer spreads and reducing the size of intra-day or day-to-day exchange rate movements. The group found, however, that sterilized intervention alone did not appear to be an effective instrument in offsetting persistent market pressure.

The group also found that closely coordinated intervention had been more effective than intervention by only one central bank. The short-term impact, however, had faded quickly when sterilized intervention operations had not been followed up by

consistent and effective measures designed to deal with underlying causes of exchange rate changes.

Intervention in cases where the exchange rate movements deviated from what authorities considered warranted by economic fundamentals was found in several cases to have been successful in buying time for either market participants to recognize such factors or for the authorities to reorient their policies. Buying time, however, had occasionally been useless or counterproductive in the absence of appropriate policy changes.

Sterilized intervention for the sake of mitigating the exchange rate impact on the domestic economy often proved ineffective. In cases where the exchange rate was appreciating, the amount of intervention required to stem or reverse the upward trend was large and intervention had to be complemented by changes in other policies. In fact, attempts to pursue exchange rate objectives that were inconsistent with the economic fundamentals tended to be counterproductive.